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No. 02-1016

In the Supreme Court of the United States

LEE M. TILL AND AMY M. TILL,
Petitioners,

v.

SCS CREDIT CORPORATION,
Respondent.

**ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT**

PETITIONERS' BRIEF ON THE MERITS

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QUESTIONS PRESENTED

1. Is an undersecured creditor entitled to the "indubitable equivalent" of its nonbankruptcy entitlement for purposes of discounting deferred payments to present value under the Chapter 13 cramdown provision at 11 U.S.C. § 1325(a)(5)(B)(ii), resulting in fixing of a subprime lender's 21% contract rate as the presumptive discount rate?

2. What is the proper method for discounting of deferred payments to present value on property retained by the debtor under the Chapter 13 cramdown provision, and what is the creditor entitled to be compensated for in calculating the appropriate discount rate of interest?

PARTIES AND RULE 29.6 STATEMENT

Petitioners

Petitioners Lee M. Till and Amy M. Till are individual citizens of the United States residing in the Southern District of Indiana. Neither Petitioner has corporate affiliations. Lee M. Till and Amy M. Till were the debtors in the Bankruptcy Court, the Appellees in the District Court and the Appellants in the Seventh Circuit Court of Appeals.

Respondent

Respondent SCS Creditor Corporation is a corporation with no parent corporation. Petitioners are unaware of any publicly held company owning ten (10%) percent or more of said corporation's stock. SCS Credit Corporation was the objecting creditor in the Bankruptcy Court, the Appellant in the District Court, and the Appellee in the Seventh Circuit Court of Appeals.

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OPINIONS BELOW

The panel opinion of the United States Court of Appeals for the Seventh Circuit (Pet. App. B at 3a) was entered on August 21, 2002 and is reported at 301 F.3d 583 (7th Cir. 2002). The Order denying petition for rehearing *en banc* (Pet. App. A at 1a) was entered by the Seventh Circuit Court of Appeals on October 10, 2002 and is reported at 2002 U.S. App. LEXIS 21282 (7th Cir. 2002). The unreported opinion of the United States District Court for the Southern District of Indiana (Pet. App. C at 34a) was issued on November 1, 2000. The unreported order of the United States Bankruptcy Court for the Southern District of Indiana (Pet. App. D at 40a) was issued on June 27, 2000.

JURISDICTION

This Court has jurisdiction pursuant to 28 U.S.C. § 1254(1). The judgment of the Seventh Circuit Court of Appeals was entered on August 21, 2002. The Court of Appeals entered an order denying a timely petition for rehearing *en banc* on October 10, 2002 (Pet. App. A at 1a). The petition for writ of certiorari was filed on January 2, 2003, and was granted on June 16, 2003.

STATUTORY PROVISIONS INVOLVED

11 U.S.C. § 1322(b)(2) provides:

* * * *

(b) Subject to subsections (a) and (c) of this section, the plan may —

* * * *

(2) modify the rights of holders of secured claims, other than a claim secured only by a security interest in

real property that is the debtor's principal residence, ...[1]

11 U.S.C. § 1325(a)(5) provides:

(a) Except as provided in subsection (b), the court shall confirm a plan if—

* * * *

(5) with respect to each allowed secured claim provided for by the plan—

(A) the holder of such claim has accepted the plan;

(B)(i) the plan provides that the holder of such claim retain the lien securing such claim; and

(ii) the value, as of the effective date of the plan,[2] of property to be distributed under the plan on account of such claim is not less than the allowed amount of such claim; or

(C) the debtor surrenders the property securing such claim to such holder; ...

STATEMENT OF THE CASE

Lee M. Till and Amy M. Till filed a petition for relief under Chapter 13, Title 11 of the United States Code on October 25, 1999. The underlying facts are not disputed. SCS Credit Corporation ("SCS") held a perfected security interest in the debtors' 1991 S-10 truck ("vehicle") retained by the debtors strictly for personal use. The amount financed under SCS's original contract dated October 2, 1998 (Jt. App. at 21) was $6,425.00, with a total sale price of $8,385.24 (including interest at the rate of 21% per annum). The principal balance on the contract as of the petition date was $4,894.89, based upon SCS's proof of claim (Jt. App. at 15-18). The "cramdown" value of the vehicle was established by agreement at $4,000.00. The proposed three-year Chapter 13 plan provided for payments by wage assignment to the Trustee in the total amount of $740.00 per month. SCS's allowed secured claim was to be paid in full concurrently with payments on other allowed secured claims, with a discount factor of 9.5 % to be paid on the declining balance of the $4,000.00 allowed secured claim from the date of confirmation (Pet. App. G at 77a-79a). The 9.5 % discount rate proposed by the debtors was based on a "formula method" (Pet. App. D at 43a) consisting of the prime rate (as of petition date) as a base, with addition of a 1.5% risk premium ("prime-plus"). SCS objected to confirmation of the plan, arguing that, under the "coerced loan" method of discounting to present value, SCS was entitled as a "subprime" lender to its 21% contract rate of interest to compensate for the return on its investment if it were permitted to foreclose on the vehicle and reinvest the proceeds in a like-kind loan (Pet. App. D at 41a).

A hearing limited to the rate of interest to be paid on SCS's allowed secured claim under 11 U.S.C. § 1325(a)(5)(B)(ii) was conducted before the bankruptcy court on February 29, 2000 (Pet. App. at 57a). The debtors' expert, a professor with a Ph.D in economics and former economist in the research department of the St. Louis branch of the Federal Reserve Bank, testified that standard lending institutions use the "prime rate," described as part of a "uniform national market" and a "national benchmark rate." According to the economist's

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[1] Unless otherwise indicated, any reference to "secured claim" throughout this brief shall be deemed to exclude any claim secured only by a security interest in property that is the debtor's principal residence.

[2] The "value, as of the effective date of the plan" language is used as a term of art in the reorganization chapters to refer to process of discounting deferred payments to present value. *See, e.g.*, (Pet. App. E).

unrebutted testimony, the "prime rate" not only accounts for the time-value of money ("a dollar now is a little more valuable that a dollar later") which the expert projected at 3.5%, but also includes adjustment for the purchasing power of the dollar (inflation rate projected at 2.5%), as well as risk and transaction costs (accounting for the 2% balance of the 8% prime rate) (Pet. App. F at 63a-64a). SCS's general manager testified that SCS does not sell vehicles on credit for a rate of interest less than 21%, and that 21% was the rate charged by other lenders in the area. (Pet. App. F at 73a). Furthermore, SCS's representative stressed that SCS and other non-prime lenders "do not like" Chapter 13 petitions because creditors often encounter delay and fail to receive full payment (Pet. App. F at 73a-74a). The Trustee recommended a "formula method" previously adopted by the courts in that district. (Pet. App. F at 60a-62a).

The Bankruptcy Court rejected the notion that the discount factor should be tied to the creditor's subprime lending status, and interpreted *Koopmans v. Farm Credit Services of Mid-America*, ACA, 102 F.3d 874 (7th Cir. 1996), to afford the court discretion to adopt the prime-plus 1.5% rate ultimately approved by the court. The matter before the Bankruptcy Court was a core proceeding within the meaning of 28 U.S.C. § 157(b)(2)(L). Exercising jurisdiction pursuant to 28 U.S.C. §§ 157(b)(1) and 1334, the Bankruptcy Court confirmed the amended Chapter 13 plan (Pet. App. D at 42a-43a).

SCS timely appealed the final order approving confirmation of the plan to the United States District Court for the Southern District of Indiana, Indianapolis Division, which exercised jurisdiction pursuant to 28 U.S.C. §§ 158(a) and 1334. The District Court reversed the Bankruptcy Court on the basis that unrebutted evidence established that a "subprime" market existed and that the established rate for the subprime lending market was 21%, which the District Court considered

the controlling inquiry under *Koopmans* (Pet. App. C at 38a). The District Court reasoned that because the Tills are in the nonprime market, they are presumably "risky debtors." (Pet. App. at 36a). According to the District Court, the changed nature of the risk of a loan once it becomes part of a Chapter 13 plan is irrelevant. (Pet. App. C at 38a).

The District Court considered the determination of the correct interest rate under § 1325(a)(5)(B)(ii) to be a "factual determination" that would not be disturbed if the bankruptcy judge's inferences are reasonable and supported by the evidence. Under the District Court's ruling, the Bankruptcy Court had no discretion to adopt the "prime plus" discount rate. (Pet. App. C at 37a).

The debtors appealed the District Court decision to the Seventh Circuit. The majority panel of judges assigned to the case interpreted *Koopmans* to mandate a "coerced loan" approach. Conceptualizing the cramdown process as forcing the creditor to extend a new line of credit to the debtor, the majority panel reasoned that "the creditor is entitled to the rate of interest it could have obtained had it foreclosed and reinvested the proceeds in loans of equivalent duration and risk", since nothing less would give the creditor the "indubitable equivalent" of its nonbankruptcy entitlement (Pet. App. B at 17a-18a). Adopting *GMAC v. Jones*, 999 F. 2d 63 (3d Cir. 1993), the majority panel concluded that the "old contract rate will yield a rate sufficiently reflective of the value of the collateral at the time of the effectiveness of the plan to serve as a presumptive rate." (Pet. App. B at 20a).

Tills timely petitioned for rehearing *en banc* (Jt. App. at 59), which was denied on October 10, 2002.

SUMMARY OF THE ARGUMENT

The majority panel below established a "rebuttable presumption" in favor of the subprime lender's 21% contract

rate for purposes of discounting deferred payments to present value at 11 U.S.C. § 1325(a)(5)(B)(ii).

Interest rates can determine the success or failure of a debtor's Chapter 13 plan.[3] The majority panel's decision defeats a fundamental purpose of Chapter 13 to enable all individuals who qualify for Chapter 13 relief under 11 U.S.C. § 109(e) to retain basic necessities -- not just those individuals who happen to be "prime" lending candidates.

The issue of allowability of interest on claims against a debtor's estate is uniquely concerned with the equitable distribution of a debtor's limited assets, and has long been determined by federal law. *Vanston Bondholders Protective Committee v. Green*, 329 U.S. 156, 162-63 (1946). Because the coerced loan approach results in such vast disparity of treatment amongst creditors, the controversy generated by the decision of the majority below is often characterized as a dispute amongst creditors rather than a debtor-creditor debate.

Congress frequently rewards certain individuals and groups with favorable interest rates. Debtors under Chapter 13 are among those singled out for special treatment under 11 U.S.C. § 1325(a)(5)(B)(ii). Consumer bankruptcy reform was considered a fundamental objective of the Bankruptcy Reform Act of 1978 ("Code"). P.L. No. 95-598, 92 Stat. 2549. Under former Chapter XIII of the Chandler Bankruptcy Act ("Act"),

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[3] Payment of an allowed secured claim in an amount of $15,000.00 at 9.5% interest (the rate adopted by the Bankruptcy Court in the case below) over the maximum five-year plan term requires base funding in an amount of approx. $18,753.00 @ $312.55/month, whereas payment of $15,000.00 at 21% over the same period requires base funding of $23,929.20 @ $398.82/month -- a staggering $5,176.20 increase in interest exclusive of the additional trustee fees generated thereon. This is typically either $5,176.20 that the debtor doesn't have -- or a $5,176.20 windfall to the subprime lender at the expense of unsecured creditors.

the court could confirm a Chapter XIII plan only if the plan had been accepted by all secured creditors whose claims were dealt with by the plan. *See* § 651 of the Chandler Act, 52 Stat. 840-940, P.L. 696, June 22, 1938. Chapter XIII was of very limited utility to debtors attempting to deal with claims secured by personal property. The generous cramdown provisions of present Chapter 13 were enacted in direct response to this problem. The Code represented a significant impairment of the rights that secured creditors had enjoyed under the Act. For the first time, under §§ 1322(b)(2) and 1325(a)(5)(B)(ii), individual debtors could modify a secured creditor's pre-petition contract rights over the creditor's objection. The coerced loan method adopted by the Seventh Circuit is "inexplicably hostile to Chapter 13 and its rehabilitative intent." Lundin, 2 Chapter 13 Bankruptcy, § 112.1 at 112-16 (3d ed. 2000).

Pursuant to 11 U.S.C. § 506(a), the amount of the creditor's "allowed secured claim" for purposes of § 1325(a)(5)(B)(ii) is measured by the value of the collateral.[4] Section 1325(a)(5)(B)(ii) addresses only the allowed secured portion of the creditor's claim -- not the entire state-law contract balance.

Section 1325(a)(5)(B)(ii) thus involves the process of *converting collateral (allowed secured claim) into a stream of deferred cash payments.* This statutory process is universally recognized to require a "present value" or "time value of money" analysis.[5]

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[4] An undersecured creditor, such as SCS, also has an unsecured claim in an amount by which the creditor's claim exceeds the value of the collateral pursuant to 11 U.S.C. § 506(b).

[5] This Court in *Associates Commercial Corp. v. Rash*, 520 U.S. 953 (1997), noted that the debtor under §1325(a)(5)(B)(ii) is required to provide the creditor with payments, over the life of the plan, that will total the

The decisions of numerous Circuits, including the Seventh Circuit below, have transformed this mechanical process of calculating the "present value" of the "allowed secured claim" into a fact-specific inquiry into a particular creditor's use of interest as a vehicle for profit in the nonbankruptcy marketplace. Under the "coerced loan" or "presumptive contract" theories, the subprime lender, charging nonbankruptcy rates as high as 40% in some states,[6] becomes a new class of preferred creditor who stands to profit immensely by reaping an unfair share of the estate's limited assets -- all at the expense of general unsecured claimants and the debtor's successful rehabilitation. Empirical data demonstrates that years after the cramdown section was enacted, secured claimants under Chapter 13 receive by far the lion's share of the estate's assets, to the exclusion of unsecured creditors.

The "coerced loan" theory "profoundly misstates" the present value concept at 11 U.S.C. § 1325(a)(5)(B)(ii). *In re Dingley*, 189 B.R. 264, 268-69 (Bankr. N.D. N.Y. 1995). The "coerced loan" or "presumptive contract" cases are based on fictional premises. There are no *loans* in the Chapter 13 cramdown statute — only "*claims.*" Not defined in the

"present value" of the "allowed secured claim," i.e., the "present value of the collateral ...." 520 U.S. at 957. Similarly, this Court in *Rake v. Wade*, 508 U.S. 464 (1993) noted that deferred cash payments under § 1325(a)(5)(B)(ii) must equal the "present dollar value" of the allowed secured claim as of the confirmation date, which implies the payment of interest. 508 U.S. 469-70.

6 *See, e.g.*, Scott F. Norberg, "Consumer Bankruptcy's New Clothes: An Empirical Study of Discharge and Debt Collection in Chapter 13," 68 Am.Bankr. Inst. L. Rev. 415, 438-39 (1999), noting that secured creditors under the cramdown provision are now presumptively entitled to interest at rates that range as high as 40% in a state like Mississippi where there is currently no legal usury rate. Miss. Code Ann. § 75-17-1.

Bankruptcy Code, a "loan" typically includes an obligation to pay *contractual* interest. There is no "market rate" for a bankruptcy "loan," because pre-petition loans become "claims" upon filing of bankruptcy. A cramdown is neither contractual, consensual nor a loan -- but rather exclusively a creature of federal statute. The purpose of cramdown is not to compensate the creditor for unrealized contract damages or profit, but rather to equate the *value of the debt* with the *value of the allowed secured claim*. 124 Cong. Rec. H11,103 (daily ed. Sept. 28, 1978)(remarks of Rep. Don Edwards); 124 Cong. Rec. S17,420 (Oct. 6, 1978)(remarks of Rep. DeConcini).

Petitioners contend that the "coerced loan" or "presumptive contract" approaches mandated by the majority panel below are prohibited by the plain language and structure of the statute. Once the myriad of inappropriate fact-specific characteristics are removed from the "present value" equation, discounting of payments to present value under § 1325(a)(5)(B)(ii) becomes a straightforward process that lends itself to predictable results. Petitioners do not contend that there is but one formula by which payments may be discounted to present value under § 1325(a)(5)(B)(ii) — or one discount rate to be applied in every case. Bankruptcy courts are thus left with discretion to apply one of various formula methods, which take into account only those factors appropriate to the statutory discounting process.[7]

ARGUMENT

Because of the mechanical nature of the present value calculation, the court in *In re Oaks Partners, LTD*, 135 B.R. 440, 445 (Bankr. N.D. Ga. 1991) noted that, the "*time value of*

7 The range of permissible results will be dramatically reduced by this process, with a substantial increase in uniformity and predictability, and a corresponding decrease in costly litigation and waste of limited judicial resources.

money" approach is commonly referred to as the "*formula*" approach urged by Petitioners.

The Seventh Circuit is not alone in its adoption of the alternate "coerced loan" method of discounting to present value. The Seventh Circuit adopted the holding of the Third Circuit in *GMAC v. Jones*, *supra*, 999 F.2d 63, and several other Circuits have adopted variations of the "coerced loan" method. *Matter of Southern States Motor Inns, Inc.*, 709 F.2d 647 (11th Cir. 1983), *cert. den.*, 465 U.S. 1022 (1984); *In re Hardzog*, 901 F.2d 858 (10th Cir. 1990); *United Carolina Bank v. Hall*, 993 F.2d 1126 (4th Cir. 1993); and *In re Smithwick*, 121 F.3d 211 (5th Cir. 1997), *cert. den.*, 523 U.S. 1074 (1998); *United States v. Arnold*, 878 F.2d 925 (6th Cir. 1989).[8]

In contrast, the Second, Eighth and Ninth Circuit Courts of Appeals have adopted one of various "formula" methods for discounting payments to present value. Under a "formula" method, the court adopts a readily accessible or national risk-free rate of interest as a base, to which a "risk premium" is added at the court's discretion corresponding to the court's determination of any special risks associated with the reorganization plan. *United States v. Doud*, 869 F.2d 1144 (8th Cir. 1989)[Chapter 12]; *In re Fowler*, 903 F.2d 694 (9th Cir. 1990)[Chapter 12]; and *In re Valenti*, 105 F.3d 55 (2d Cir. 1997)[Chapter 13][abrogated on other grounds by *Rash*, *supra*, 520 U.S. 953].

Petitioners contend that the most direct method to arrive at an appropriate discount factor is use of a formula method with

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[8] The continued viability of the "coerced loan" method of discounting to present value in the Sixth Circuit is called into serious question by the most recent Circuit case of *In re Kidd*, 315 F. 3d 671 (6th Cir. 2003), in which the Sixth Circuit Court of Appeals flatly rejected the 20.95% subprime contract rate.

a readily accessible national rate base. If the chosen national rate is truly risk-free, a risk premium may be added at the discretion of the bankruptcy court upon the creditor's demonstration of uncompensated risk. On the other hand, an additional risk premium may be unnecessary — for instance, because the chosen national rate already includes a risk allowance, or because the higher *Rash* replacement value has eliminated the necessity for inclusion of an additional risk premium.

I. CHAPTER 13 EXPRESSLY PERMITS MODIFICATION OF CONTRACTUAL INTEREST RATES IN EXCHANGE FOR PAYMENT OF THE ALLOWED SECURED CLAIM AT STATUTORY PRESENT VALUE

A. Historic Concept of Discounting of Deferred Cash Payments to Present Value

Although Congress neither established a single discount rate applicable to all bankruptcy cases nor specified a particular method for determining an appropriate discount rate under 11 U.S.C. § 1325(a)(5)(B)(ii), the legislative history of the cramdown sections describes the mechanical process of determining present value in a manner consistent with the use of the term by the economic and financial communities. H.R. Rep. No. 95-595, U.S. Code Cong. & Admin. News 1978, p. 6464, as appearing in 2 Appendix *Collier on Bankruptcy* at 408; H.R. Rep. No. 95-595, 95th Cong., 1st Sess., 414-15 (1997).

"Present value" or the "time value of money" is not a legal concept, but rather a term of art in the financial community. The present value rule dates back to the work of the great American economist Irving Fisher in 1930. Irving Fisher, The Theory of Interest (1st ed. 1930). To compensate the creditor for not receiving its money (i.e., value of collateral or allowed

secured claim) today, the debtor is charged an additional amount of money based on a rate of interest called a "discount rate." E. Grant & W. Ireson, Principles of Engineering Economy 35 (4th ed. 1964). As explained by Robert W. Hamilton in Fundamentals of Modern Business (4th ed. 1989), relatively simple "formulae" permit a direct comparison of the value of amounts to be paid at different times. The process by which amounts payable at different times are made comparable is referred to as "discounting" or reducing future payments to present value; *Id.* at p. 29. When speaking of the earning power of a present amount over time, one usually speaks of the "interest rate." When computing the "present value" of a future payment, one usually speaks of the "discount rate;" however, it is the same rate since the "present value" of a future sum and the "future value" of a present sum involve precisely the same calculation examined from opposite perspectives. *Id.* at p. 30.[9]

Paul A. Samuelson, in his renowned treatise, defined "market rate of interest" as follows:

> *Definition*: The market rate of interest is that percentage return per year which has to be paid on any safe loan of money, which has to be yielded by any safe bond or other security, and which has to be earned on the value of any capital asset (such as a machine…) in any competitive market where there are no risks or where all risks have already been taken care of by special premium payments to protect against risk.[10]

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[9] Present value is easily computed by reference to readily available financial tables. J. Weston and E. Brigham, Managerial Finance 244-71 (6th ed. 1978).

[10] Economists historically use the term "market rate of interest" to mean the pace at which the national economy flows based on supply and demand.

Paul A. Samuelson, Economics 575 (8th ed. 1970).

Present value as understood at the time of adoption of § 1325(a)(5)(B)(ii) and as understood now is defined by economics as the discount to present value of a payment stream using a riskless rate plus some risk premium related to the payment stream in question. A "risk-adjusted discount rate" is thus defined in economics as follows:

> …the risk-free rate (generally the return on short-term U.S Treasury securities) plus a risk premium that is based on an analysis of the characteristics of the particular investment or project.

John Downes and Jordan Elliott Goodman, Dictionary of Finance and Investment Terms 594 (6th ed. 2003).

Similarly, "discount rate" is defined as the:

"Coerced loan" theorists redefine "market rate of interest" as the rate the lender charges to similarly situated borrowers in the lender's particular (e.g., "subprime") market. Petitioners contend that there is a difference between applying a "market rate of interest," as opposed to calculating present value by use of a risk-free base (e.g. treasury bill rate) that is "market" sensitive. One illustration of this distinction is the fact that 11 U.S.C. § 362(d)(3)(B) specifies that interest is to be paid at the current "market rate" ("market rate" being the end result). In contrast, the Code sections contemplating a "present value" calculation do not specify interest to be paid at "market rate," and a market-sensitive risk-free base is merely a means to an end (present value being the end result). The labeling of the interest to be paid at § 1325(a)(5)(B)(ii) as "market rate" interest is a misnomer which has led to extreme variations in the discounting process as a result of each lender's attempt to establish its "market" as controlling. The "coerced loan" approach introduces characteristics of the submarket for loans in a particular industry, wholly irrelevant to the value of the secured creditor's interest in the collateral. A lender in the lucrative subprime lending market can thus reap cramdown interest rates of 20-40% unprecedented in present-value calculations in the economic community.

1. interest rate that the Federal Reserve charges member banks for loans, using government securities…as collateral. This provides a floor on interest rates, since banks set their loan rates a notch above the discount rate ….

2. interest rate used in determining the PRESENT VALUE of future CASH FLOWS ….

Id. at 181 (emphasis in original).

(Advent of Subprime Lending and Establishment of Finance Company Affiliates by Major Auto Manufacturers in the Non-Bankruptcy Marketplace)

Following enactment of the Code, it was several years before the "coerced loan" method with its statutory embellishments took root.

Then, in the late eighties and early nineties, automobile lending began to become extremely lucrative. Virtually every major auto manufacturer established a lending arm.[11] These finance company affiliates of the major auto manufacturers have made auto loans with rates as low as 0%[12] and recouped

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[11] In December 1996, Ford Motor Credit Company announced an ambitious plan to extend its lending reach into the "subprime" lending market. The reported lure was the $100 billion that consumers with flawed credit ratings borrow each year to buy new and used cars, and the interest rates of 18-40% that such lenders charge on loans in that market — the equivalent of paying for a car at credit card rates. Robyn Meredith, "Financial Powerhouse Takes Aim at Bad Credit Risks," New York Times (December 15, 1996). The credit industry thus campaigns to tighten debtor access to bankruptcy relief even as it expands its high-risk lending practices.

[12] Such contracts result in a presumption of "0%" cramdown interest under the majority panel's incongruous analysis. A similar dilemma was posed by Judge Lundin:

this credit subsidy to borrowers by receiving "subvention" payments from the auto manufacturers and auto dealers. "The Separation of Banking and Commerce," http://www.public-gis.org/reports/sbc.html (p.11).

Some evidence suggests that auto company use of credit to promote auto sales has resulted in an overall deterioration of credit standards in the auto loan market, affecting auto loans made by banks as well as captive finance companies. In recent years, auto loans with five-year terms have become commonplace, yet, such auto financing entails considerable risk since on average the borrower has no equity in the financed auto until the 37th month after purchase. *Id.* at p. 43.[13] In the case of an auto purchase with subsidized credit, both the subvention payment and cash rebate indirectly raise the purchase price and are considered part of the purchase price on the cut-rate auto loan, resulting in imposition of higher costs on less sophisticated consumers. *Id.* at p. 44. A lender

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> If GMAC was running a '1.9 APR special' alongside a 'standard' 20 percent car loan, is the promotional rate ignored for § 1325(a)(5) purposes….? On careful scrutiny, most lenders offer many different 'regular' interest rates for the same loan. Does [this] require the bankruptcy courts … to parse through every lender's portfolio to find the right market rate; and if so, on what logic would a bankruptcy court include some available rates and reject others?

Lundin, 2 Chapter 13 Bankruptcy § 112.1 at 112-20 - 112-21 (3d. ed. 2000).

[13] The American Bankers Assoc. reported that the delinquency rate on banks' indirect auto loans (loans through auto dealers) was 47% higher than the delinquency rate on auto loans made directly by the banks; according to the Consumer Bankers Assoc., intense competitive pressures in the auto loan market have forced banks to resort to indirect lending, which now accounts for 78% of auto loans made by banks. "The Separation of Banking and Commerce," *supra*, http://www.public-gis.org/reports/sbc.html(p.43).

typically structures its loan repayment to accommodate the possibility that the value of the collateral may ultimately be less than the balance due on its note.

From the 1990s to present, there has similarly been a tremendous growth in the "subprime" lending market. Subprime borrowers typically have at least one serious blemish on their credit history, or no credit history at all. The former group might have significantly impaired credit histories with multiple delinquencies and charge-offs, as well as relatively low household incomes of $20,000.00 - $40,000.00 annually. The latter group might include recently divorced or separated persons who do not have an independent credit history. Annual originations of subprime auto loans range from $40 billion to $70 billion, or between one-tenth and one-sixth of total auto finance originations. Most companies in this sector finance loans ranging between $5,000.00 - $14,000.00. The adjusted periodic rates (APRs) to borrowers generally exceed 15% and averaged 22% (as of 1998) for the entire subprime industry, capped by local state usury laws. However, many of these loans are purchased at discount, which effectively takes the yield over state usury caps. "Subprime Auto Finance: The Year of the Bankruptcies" (ABI Journal May 1998), http://www.abiworld.org/abidata/online/journaltext/98myturn.html.[14] Inherent in the panel majority's presumptive-contract

[14] "Predatory loans" are a subset of subprime loans. A "predatory loan" typically has one or more of the following features: 1) charges more in interest and fees than is required to cover the added risk of lending to borrowers with credit imperfections; 2) contains abusive terms that trap borrowers and lead to increased indebtedness; 3) fails to take into account the borrower's ability to repay the loan, and/or 4) violates fair lending laws by targeting senior citizens, women, and minorities. National Community Reinvestment Coalition Position Paper on Predatory Lending, "Subprime and Predatory Lending Defined," http://www.ncrc.org. It is generally recognized that, while most subprime loans are not predatory, the subprime

approach is the advocacy of a highly suspect national policy -- that those lenders who are more successful at interest-rate gouging will be rewarded to the detriment of other creditors in the common pool.

There is also evidence that the higher interest rates charged by subprime lenders cannot be fully explained solely as a function of the "additional risks" presented by these loans. Howard Lax, Michael Manti, Paul Raca, and Peter Zorn, Subprime Lending: An Investigation of Economic Efficiency, Freddie Mac, 2000. Also, analyses by Fannie Mae and Freddie Mac suggest that subprime lending is occurring with borrowers whose credit would in fact qualify them for conventional loans. Center for Community Change, October 17, 2001, http://www.communitychange.org.[15]

The advent of subprime lending and the establishment of finance company affiliates of the major auto lenders has thus effectuated a major change in pre-bankruptcy lending dynamics that make traditional assumptions concerning the pre-bankruptcy fixing of interest rates highly unreliable. This turmoil in the non-bankruptcy marketplace further

market is fertile ground for predatory lending. *See, e.g.*, Center for Community Change, October 17, 2001, http://www.communitychange.org.

[15] It has been estimated that 25%-30% of subprime borrowers would qualify for conventional loans. *See, e.g.* Ron Elwood, Legal Services Advocacy Project, "State and National Eyes Focused on Predatory Lending," Minnesota Legal Services Coalition, http://www.mnlegalservices.org/lsap//end.shtml. The District Court's rationale that the Tills' status as subprime borrowers justifies discriminatory treatment under the Bankruptcy Code is particularly troubling. See District Court Order (Pet. App. A at 36a), where the District Court stated: "Potential borrowers are in this non-prime market because their credit histories are poor and they are therefore risky debtors. Presumably these borrowers cannot find a lender in the prime market."

demonstrates the perils of attempting to incorporate pre-bankruptcy lending practices into a uniform federal statute such as the Bankruptcy Code.

B. The Plain Meaning of Section 1325(a)(5)(B)(ii) Supports Petitioners' Interpretation of the Statute

Beginning with the statutory language, it is apparent that Congress described the obligation to pay plan interest under the reorganization chapters in very different terms from the obligation to pay pendency interest under § 506(b), which refers to "…fees, costs or other charges provided for under the agreement under which such claim arose." Section 362(d)(3)(B) addresses the period prior to confirmation, when a debtor is required to pay interest at the current fair "market rate" on the value of the secured claimant's interest in the real estate. The fair "market rate" language at § 362(d)(3)(B) suggests a retail rate available to the owner of similar real estate in that particular market. Robert G. Quila, "Cramdown Interest Rate: Second Circuit Court of Appeals Addresses What It Is and What It Is Not," 6 J. Bankr. L & Prac. 549, 555 (1997). Therefore, one must conclude that the present value discount required under the cramdown provision is something different from the current retail "market rate."[16] *Id.* at 556. A "plain language" interpretation of the statute suggests a simple payment stream discounted to reflect the present value of the "allowed secured claim" in a fixed amount, without any additional creditor-debtor fact-based considerations. Michael E.S. Frankel, "The Emerging Fixed Cramdown Rate Regime: A Market-Driven Argument for Effective Fixed Rates in

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[16] The legislative history of the cramdown provisions of the Bankruptcy Reform Act refers to "the discount rate" rather than a "market rate of interest." S. Rep. No. 989, 95th Cong., 2d Sess. 414-15 (1978), *reprinted in* 1978 U.S. Code Cong. & Admin. News 6370-71.

Bankruptcy Cramdown," 2 Chi. L. Sch. Roundtable 643 n.75 (1995).

Under common rules of construction, where a word or term has a judicially settled meaning, it must be presumed that Congress has used it in that sense where it appears in a statute. *Gilbert v. United States*, 370 U.S. 650, 655 (1962). Congress speaks with careful precision, and its words mark the exact spot at which it stops. *The Scotland*, 118 U.S. 507 (1886). It is at once apparent that § 1325(a)(5)(B)(ii) contains none of the "words" essential to the "coerced l*oan*" and "presumed *contract*" theories — no use of the word "contract," "loan," or "market rate."

C. Petitioners' Present Value Interpretation is Consistent with the Structure of Chapter 13

As noted by this Court in *United Savings Ass'n v. Timbers of Inwood Forest Associates*, 484 U.S. 365, 371 (1988), a provision that may seem ambiguous in isolation is often clarified by the remainder of the statutory scheme.

Not only is the "present value" language used throughout the reorganization chapters, but only the Petitioners' interpretation produces a substantive effect compatible with the rest of the Code.

Section 1325(a)(5)(B)(ii) is the very statute by which the § 1322(b)(2) right of contract modification is implemented. By imposing a rebuttable presumption in favor of the pre-petition contract rate under § 1325(a)(5)(B)(ii), the majority panel below creates irreconcilable conflict between the two statutes and renders the § 1322(b)(2) modification rights unworkable. This Court in *Citizens of Maryland v. Strumpf*, 516 U.S. 16, 20 (1995) cautioned against such convoluted interpretation of a statute, "[w]hen [a] perfectly reasonable reading [of the Code] is available…" Surely one of the most fundamental rights afforded to debtors under Chapter 13 cannot so readily be

eliminated by the Court under a construction at odds with all other "present value" language in the Code and not expressed anywhere in the statute.[17]

The "coerced loan" approach upsets the symmetry of the Code in other critical respects. 11 U.S.C. § 506(b) allows an oversecured creditor to add interest that accumulates prior to confirmation to the secured claim awaiting distribution under the debtor's plan. The post-petition interest under § 506(b) becomes part of the secured claim and may accrue until the effective date of the plan. Upon confirmation, § 1325(a)(5)(B)(ii) requires that payments made under the plan return the "present value" of the § 506(b) secured claim amount to the creditor. In the case of an oversecured creditor, §§ 506(b) and 1325(a)(5)(B)(ii) compliment each other and together ensure the full payment of the present value of the secured creditor's claim. *In re Harko*, 211 B.R. 116, 123 (2d Cir. BAP 1997), *aff'd*, 141 F. 3d 420 (2d Cir. 1998), *cert.den.*, 525 U.S. 872 (1998). As a result of the reference to the "agreement under which such claim arose" at § 506(b), the contract rate of interest is frequently applied under § 506(b). Under the majority panel's interpretation of § 1325(a)(5)(B)(ii), certain classes of secured creditors (e.g. subprime lenders) are singled out for special treatment over prime lenders and oversecured creditors whose secured claims

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[17] Under the Bankruptcy Act, safeguards were provided to protect the rights of secured creditors only to the extent of the value of their property, and there was no constitutional claim of the creditor to insist that the statute required anything more; this Court recognized that the Act must be liberally construed to give the debtor the full measure of the relief afforded by Congress. *John Hancock Mutual Life Ins. Co. v. Bartels*, 308 U.S. 180, 186-87 (1939).

arise from statute.[18] The substitution of a contract rate of interest for "present value" interest under § 1325(a)(5)(B)(ii) ignores the different objectives of these two sections.

Under 11 U.S.C. § 1325(a), the court "shall" confirm the plan if certain minimal requirements for confirmation are met. Under § 1325(a)(5)(A), the debtor need not satisfy § 1325(a)(5)(B) if the creditor fails to object to the plan. Requiring the debtor to "come forward with evidence" to support any below-contract interest rate renders § 1325(a)(5)(A) a nullity.

It is a well-recognized canon of construction that words repeated within the same statutory section have an identical meaning in the several places employed. *George Van Camp & Sons Co. v. American Can Co.*, 278 U.S. 245 (1929). The "value, as of the effective date of the plan" language appears throughout the reorganization chapters (Pet. App. E at 45a-51a), and has consistently been interpreted under a "present value" analysis to require that payments be adjusted "to allow for the changing value of a dollar". *See*, e.g., *United States v. Neal Pharmacal Co.*, 789 F. 2d 1283 (8th Cir. 1986) [method for determining proper discount rate is same under § 1129(a)(9)(C) for unsecured tax claims as § 1129(a)(7) for secured cramdown]. In sharp contrast, under the majority panel's ruling, every unsecured claimant would be entitled to a different interest rate based on its contract or lending market when a debtor must pay "value, as of the effective date of the plan" to unsecured claimants to satisfy the best-interests-of-creditors test under § 1325(a)(4). Lundin, 2 Chapter 13 Bankruptcy § 112.1 at 112-8 (3d. ed. 2000). To impose a fact-specific interpretation on the present-value calculations

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[18] Contrast the 21% presumptive interest rate afforded to the subprime lender by the Court below and the 5% statutory interest rate currently paid on federal income tax underpayments under 26 U.S.C. § 6621.

throughout the statute creates "patent absurdity" within a statute that under Petitioners' view would easily be read as a cohesive whole. *BFP v. Resolution Trust Corp.*, 511 U.S. 531, 563 (1994).

D. Petitioner's Present Value Interpretation is Consistent With Important Policies Underlying Chapter 13

Although policy considerations may be irrelevant in a case where the language of the statute is clear, *Patterson v. Shumate*, 504 U.S. 753 (1992), the majority panel below makes certain presumptions regarding "Congressional intent." Petitioners will therefore briefly address the intent actually expressed by Congress.

The legislature has expressed a clear intent to encourage filing of Chapter 13 reorganizations over Chapter 7 liquidations. H.R. Rep. No. 95-595, 95th Cong. 2d Sess. 118,129, *reprinted in* 1978 U.S. Code Cong. & Admin. News 5963, 6080, 6090.[19] Chapter 13 envisioned a new arrangement amongst the debtor and his or her creditors — not a mere continuation of a pre-petition agreement. The drafters of the Code clearly intended to strengthen the hand of debtors in dealing with their secured creditors. According to the House Report, "one of the most significant changes from current law ... is the treatment of secured creditors and secured claims," to give the secured creditor the "value" of its property rights. Margaret Howard, "A Symposium on Bankruptcy Reform: An Agenda for the Next Century: Essay: Secured Claims in Bankruptcy: An Essay on Missing the Point," 23 Cap. U.L.

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[19] During 2002, 1,103,029 non-business Chapter 7 filings were reported nationwide, in comparison to 454,293 non-business Chapter 13 filings during the same period. Annual U.S. Non-Business Bankruptcy Filings by Chapter, http:www.abiworld.org/stats/nonbuschapter.html.

Rev. 313, 315 (1994), *citing* H.R. Rep. No. 595, 95th Cong., 1st Sess. 180 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6141. The drafters of the Code clearly intended to strengthen the hand of debtors in dealing with their secured creditors. The majority panel's imposition of the 21% pre-petition contract rate of interest is "demonstrably at odds with the intentions of the drafters." *BFP*, *supra*, 511 U.S. at 563.

Another goal of Chapter 13 is efficiency of administration. The emergence of fact-specific inquiries (and the need for evidentiary hearings to resolve otherwise routine present value calculations) can overwhelm the bankruptcy courts' limited judicial resources and substantially increase the costs of administration of the typical Chapter 13 case.[20] The loan market currently passes the costs associated with inefficient and unpredictable cramdown procedures onto the borrower in the form of higher interest rates.

Equality of distribution amongst creditors is a fundamental policy of bankruptcy law. Underlying the legislative scheme of Chapter 13 is the premise that unsecured creditors receive greater repayment in Chapter 13 than in Chapter 7, and that the

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[20] The costs of collection in Chapter 13 consume a high percentage of debtor plan payments. The debtor must pay a filing fee of $185.00, and an attorney's fee typically ranging from $1,000.00 - $2,000.00. David A. Lander, "Essay, A Snapshot of Two Systems That Are Trying to Help People in Financial Trouble," 7 Am. Bankr. Inst. L. Rev. 161, 172 (1998). For services including collection and disbursement of plan payments, the trustee is entitled to compensation up to 10% of all payments made under the plan, subject to a statutory cap. 28 U.S.C. § 586(e). Chapter 13 costs paid by debtors are in effect financed by unsecured creditors. Another study found that routine non-business Chapter 13 cases require on average nearly three times more court time per case than non-business Chapter 7 cases. Gordon Bermant et. al., "A Day in the Life: The Federal Judicial Center's 1988 – 1989 Bankruptcy Court Time Study," 65 Am. Bankr. L. J. 491, 492-93 (1989).

higher costs of Chapter 13 relative to Chapter 7 are warranted by the greater repayment of unsecured creditors. However, almost no empirical evidence validates this assumption. Norberg, *supra*, 68 Am. Bankr. Inst. L. Rev. at 417-18. The Norberg study concluded that unsecured creditors collect very little of their claims in Chapter 13. Norberg described the vast disparity of treatment of unsecured and secured claimants under Chapter 13 as follows:

> In sharp contrast to unsecured creditors, secured creditors fared handsomely in chapter 13....Approximately 90% of all chapter 13 payments (excluding attorneys' fees) went to secured creditors. While only about one-third of the debtors obtained a discharge, secured creditors collected nearly two-thirds of their claims....

Id. at 418.

Norberg concluded that the future promises even lower distributions to general unsecured creditors in Chapter 13:

> ....In practice, the Fifth Circuit's ruling [in *Smithwick*] is shifting far more dollars from unsecured to secured creditors' pockets than the *Rash* decision regarding valuation.

Id. at 438-39 (*also citing GMAC v. Jones*, and *Memphis Bank*, *supra*, et. al.).

Despite Congress' efforts to redistribute the balance of power from secured claimants to general unsecured claimants and in favor of a debtor's successful reorganization, the Bankruptcy Reform Act of 1978 has yet to fulfill these most fundamental objectives.

E. Petitioners' Present Value Interpretation is Consistent With This Court's Prior Cases

The reasoning of several key decisions of this Court is contrary to the conclusion of the panel majority.

Pursuant to 11 U.S.C. § 1322(b)(2), Chapter 13 debtors can modify the rights of secured creditors such as SCS. According to this Court in *Nobelman v. American Savings Bank*, 508 U.S. 324, 329 (1993), the "rights" implicated by § 1322(b)(2) are *those rights provided by state law*, including the *contractual interest rate*. *Nobelman* established that a creditor's state-law property rights are recognized in bankruptcy *only* in the absence of "controlling federal law."

Because this Court in *Rash, supra,* 520 U.S. 953, recognized the cramdown provision as "controlling federal law," this Court, unlike the majority panel below, rejected the argument that the creditor should be placed in the same economic position that it would have been had it exercised its state-court foreclosure rights.

This Court in *Timbers, supra,* 484 U.S. at 372, determined that a creditor's "interest in property" means its security interest (value of collateral or allowed secured claim) *without* taking into account the creditor's state-law right to immediate possession of the collateral on default or lost opportunity costs resulting from the creditor's inability to liquidate the collateral pending confirmation of a Chapter 11 plan.

Distilled to its barest essence, the "coerced loan" theory adopted by the majority panel is an argument for compensating the creditor for "lost opportunity costs" which result when the creditor is denied the ability to immediately liquidate the collateral and reinvest the proceeds. Under the language of the cramdown statute, the creditor is to be compensated *only* for the *fixed amount of the allowed secured claim* (an amount strictly limited to the value of the property securing the debt).

124 Cong. Rec. H. 11,103 (daily ed. Sept. 28, 1978); 124 Cong. Rec. S. 17,420 (daily ed. Oct. 6, 1978). *Timbers* has been read to remove the elements of profit and lost opportunity costs from the present value calculation. Hon. John K. Pearson, "Ending the Judicial Snipe Hunt: The Search for the Cramdown Interest Rate," 4 Am. Bankr. Inst. L. Rev. 35, 52 (1996). *Timbers* recognized the fact "that secured creditors do not bear one kind of reorganization cost hardly means that they bear none of them." *Id.* at 379.

This Court in *United States v. Ron Pair Enter., Inc.*, 489 U.S. 235 (1989), preserved the traditional distinction between pre-petition contract interest and post-petition bankruptcy interest when it established that payment of pendency interest to an oversecured creditor under 11 U.S.C. § 506(b) is *noncontractual.* If pendency interest under § 506(b) is *noncontractual*, there is certainly no argument that present value payments following confirmation (which novates the debtor's pre-petition agreements) is *contractual.*

This Court in the pre-Code case of *Vanston Bondholders, supra*, 329 U.S. at 163-64, noted that the "touchstone" of every decision on the allowance of interest in bankruptcy reorganizations has been a balance of the equities between creditor and creditor or between creditors and the debtor, thus forewarning of the gross equities which result when a particular class of creditors -- in the present case the subprime lender -- is arbitrarily singled out for preferred distribution of the debtor's limited resources.

Although this Court has never considered the appropriate discount rate in the context of the Bankruptcy Code, this Court has previously examined discounting to present value in other contexts. In *Commissioner of Internal Revenue v. National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 150 (1974), this Court described the economics underlying "discount" to adjust for the difference between the interest prescribed in the

instrument issued and the prevailing *market rate* for money, in much the same way the market rate concept was originally intended by commentators to distinguish "present value" plan interest from contract or pendency interest.

In the context of discounting lost future earnings to present value, this Court in *Jones & Laughlin Steel Corp. v. Pfeifer,* 462 U.S. 523, 537 (1983) concluded that the discount rate should be based on the rate of interest that would be earned on the best and safest investments, and noted that the arithmetic necessary for discounting may be simplified through use of present value tables standard in the financial community. *Id.* at 537. Although these nonbankruptcy cases did not adopt an exclusive federal rule (for discounting awards of future damages to present value), *Chesapeake & Ohio Railway Co. v. Kelly*, 241 U.S. 485 (1916), these cases are important for several reasons. First, this Court in *Pfeifer* concluded that *federal law* applies in determining the method for discounting to present value where the cause of action is rooted in federal statute. *Id.* at 547. Second, this Court applied terms employed by the financial and economic communities to describe the limited function of the present value concept and to establish guidelines as to what factors could be considered and what losses must be excluded from the discounting process. Under a traditional economic analysis, this Court in *Pfeifer* recognized that the market interest rate consists of two components: a) the real interest rate which is essentially constant over time (i.e., between 1 – 3%) and b) an estimate of anticipated inflation. *Id.* at 542.[21]

[21] *See* David R. Herwitz and Matthew J. Barrett, Accounting for Lawyers p. 206 (3d ed. 2001) [analysts' projection of real rate of interest between 2–3 % per year]; a survey of economists in Oct. 2002 generated a consensus inflation expectation of 2.3% for 2003. "Economic Trends," Federal Reserve Bank of Cleveland, p. 2 (Nov. 2002), http://www.clev.frb.org./research/Et2002/1102/Trends.pdf.

Perhaps most importantly, commentators who have examined the primary methods of discounting approved by the Supreme Court in this context, have concluded that the alternate models are essentially equivalent in that they yield the same present value when properly applied -- thereby simplifying and standardizing the process of damage assessment, and greatly reducing the variation amongst awards in similar cases.[22] This Court has thus adopted an approach to these cases that adheres to historic economic concepts of discounting and avoids the wild variations and windfalls that result from the demands of special interest groups.

II. FUNDAMENTAL ERRORS OF THE SEVENTH CIRCUIT AND OTHER CIRCUITS ADOPTING COERCED LOAN OR PRESUMPTIVE CONTRACT METHODS

A. Unfounded Presumptions of Legislative Intent

Despite the fact that the majority panel below considered the language of § 1325(a)(5)(B)(ii) to be unambiguous (Pet. App. A at 11a, n.4), the Court oversteps the statute and embarks upon a path of presumptions.

The Seventh Circuit begins with the presumption that § 1325(a)(5)(B)(ii) must place the secured creditor in an economic position equivalent to the position it would have occupied had the debtor-creditor relationship been terminated under § 1325(a)(5)(C). From there, the Seventh Circuit reaches the foregone conclusion that the "creditor is entitled to the rate

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[22] *See, e.g.*, Gary A. Anderson and David L. Roberts, "Economic Theory and the Present Value of Future Lost Earnings: An Integration, Unification, and Simplification of Court Adopted Methodologies," 39 U. Miami L. Rev. 723, 750 (1985) [concluding that the "nominal growth in earnings," "real growth in earnings," and "differential discount rate" models yield the same present values when properly applied].

of interest it could have obtained had it foreclosed and reinvested the proceeds in loans of equivalent duration and risk." (Pet. App. A at 11a-12a, 17a-21a).

The Seventh Circuit's analysis is premised upon several assumptions that have been rejected by this Court. For instance, this Court in *Rash*, *supra*, 520 U.S. at 954, made clear that "[s]urrender and retention [of collateral] are not equivalent acts."

In mandating that the element of profit be included in the present value calculation, the majority below actually concluded that there exists a "statutory directive" (Pet. App. A at 19a) that the creditor be placed in the same position that it would have been in had it been permitted to repossess the collateral. In stark contrast, this Court in *Rash* recognized that modification of state-law remedies is in fact a central purpose of the bankruptcy laws:

> ....In allowing Chapter 13 debtors to retain and use collateral over the objection of secured creditors, however, the Bankruptcy Code has reshaped debtor and creditor rights in marked departure from state law....The Code's cram down option displaces a secured creditor's state-law right to obtain immediate foreclosure upon a debtor's default....

520 U.S. at 964.

State laws reflect the policy decisions of each state concerning the proper balance between creditor and debtor rights. *See, e.g. BFP, supra*, 511 U.S. at 540. In adopting the Bankruptcy Code, Congress struck its own balance between the interests of debtors and creditors.[23]

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[23] This Court has noted that "all bankruptcy law...modifies the procedural rights available to creditors to protect and satisfy their liens." *United States v. Whiting Pools, Inc.*, 462 U.S. 198, 206 (1983). "The Bankruptcy Code

As in *Rash*, state law is not "displaced" by modification of the creditor's contractual interest rates, because there simply is no state law regarding the rights of secured creditors in Chapter 13 cramdown. State-law contracts are routinely discarded in bankruptcy.[24]

The Seventh Circuit's "contract presumption" approach to cramdown interest is all the more inexplicable given the fact that the Seventh Circuit had already had occasion to examine the issue almost 20 years earlier in the case of *Matter of Burgess Wholesale Mfg. Opticians, Inc.*, 721 F.2d 1146 (7th Cir. 1983).[25] In *Burgess*, the Seventh Circuit interpreted "value, as of the effective date of the plan" at 11 U.S.C. § 1129(a)(9)(C) as strictly a "time value of money" concept to require that plan payments be discounted to "present value" as of the effective date of the plan. Although the Court in *Burgess* did not define the method for determining "present value," the *Burgess* decision had been cited as Seventh Circuit precedent distinguishing the concepts of statutory "present

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provides secured creditors various rights, ..., and these rights replace the protection afforded by possession." *Id.* at 207.

[24] There are numerous instances in which the Code alters pre-bankruptcy entitlements to advance a specific bankruptcy policy, *see, e.g.*, § 547(b)(trustee avoidance of preferential transfers); § 510(c)(equitable subordination of claims); § 365 (presumption that executory contracts are rejected); unsecured creditors are typically denied their state-law entitlements as a result of the reorganization.

[25] The contrast between the Seventh Circuit's analyses in *Burgess* and *Till* is striking. Since the statutory language remained unchanged between 1983 when *Burgess* was decided and the 2002 *Till* decision, the Seventh Circuit's dramatic shift in interpretation may best be explained by extra-judicial factors that accompanied the advent of the "coerced-loan" theory with the influx of subprime lending between the early 1980s and 1990s.

value" and "contractual interest." The Seventh Circuit in *Till* made no attempt to reconcile — nor to even acknowledge — its dramatic shift from the statutory present value concept in *Burgess* to the state law contractual interest concept in *Till*.

B. Contract Presumption Rule is Matter for Congress-- Not the Courts

Petitioners contend that those Circuits which have created a "rebuttable presumption" in favor of the contract rate of interest for discounting of deferred payments to present value in all Chapter 13 cramdowns have undertaken judicial legislation contrary to this Court's admonitions.

In overturning the Seventh Circuit's creation of a "rebuttable presumption" in favor of the foreclosure sale price in the case of *In re Bundles*, 856 F.2d 815 (7th Cir. 1988)(abrogated by *BFP*, *supra*, 511 U.S. 531), this Court in *BFP* noted that § 548(a)(2) goes out of its way to avoid use of the standard term "fair market value" which appears elsewhere in the Code.[26] This Court concluded that the problem with adopting a fixed standard for "reasonably equivalent value" is that such judgments represent "policy determinations that the Bankruptcy Code gives us no apparent authority to make." 511 U.S. at 536-40. *Accord*, *United States v. Noland*, 116 S.Ct. 1524, 1526-28 (1996)[judicial rules may not be established at a level of generality more appropriate for legislative

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[26] This Court in *BFP*, *supra*, noted that the fact that "Congress acts intentionally and purposely when it includes particular language in one section of a statute and omits it in another," is even stronger when the omission entails the replacement of standard legal terminology (in that case, "fair market value" and in this case "contract") with a "neologism" (in that case, "reasonably equivalent value" and in this case, "value, as of the effective date of the plan"). 511 U.S. at 537.

enactment]. Where Congress has intended to create a presumption, it has not hesitated to do so in the statute itself.[27]

The practical confusion resulting from the Court of Appeals' creation of presumptions by judicial fiat has not gone unnoticed. As one commentator described the dilemma created by the Third Circuit's presumption of contract interest in *GMAC v. Jones* (which the Seventh Circuit adopted verbatim):

> Whether the 'rebuttable presumption' creates a burden of persuasion or just an obligation to introduce evidence is unclear. So is the identity of the party who bears the burden because the court spoke not only of the failure of the creditor to 'come forward with persuasive evidence' but also of a need sometimes to 'require the debtor to come forward with some evidence' about whether or not the contract rate is a good measure of the rate the creditor does or would charge currently for similar loans. The court admitted that it was inventing this by fiat as a rule of practice to aid and speed administration, and admitted that an old contract rate is a past matter, likely to be wrong often by a large amount.

Patrick Halligan, "Cramdown Interest, Contract Damages, and Classical Economic Theory," 11 Am. Bankr. Inst. L. Rev. 131, 150 (2003), *citing GMAC v. Jones*, *supra*, 999 F.2d at 70-71.

A review of reported bankruptcy court cases shows that the problems created by a court's insertion of "rebuttable presumptions" into the cramdown statute are far from

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[27] Thus, 11 U.S.C. § 707(b) provides that "there shall be a "presumption" in favor of granting the relief requested by the debtor (Chapter 7 relief over objection based on "substantial abuse"); 11 U.S.C. § 523(a)(2)(C) provides that certain debts are "presumed" to be nondischargeable.

academic. The case of *In re Richard*, 241 B.R. 403 (Bankr. E.D. Tx. 1999) expresses serious concerns that can now be heard in bankruptcy courts across the country in Circuits that have adopted the coerced loan or presumptive contract methods. The court in *Richard* concluded that *Smithwick* had established a rebuttable presumption in favor of the contract rate, as well as a creditor-specific evidentiary standard for rebutting the presumption.

Noting the unenviable plight of the Chapter 13 debtor burdened with this "rebuttable presumption" and the fact that Congress has never consented to demands for statutory recognition of the contract rate, the court concluded that:

> .... the dramatic shift in favor of secured creditors which Smithwick imposes may not only be unwarranted, but contrary to the overall rehabilitative intent of Chapter 13....

241 B.R. at 410.

C. Misapplication of the Legislative History

This Court has stated that appeals to legislative history are well taken only to resolve statutory ambiguity. *Toibb v. Radloff*, 501 U.S. 157, 162 (1991). Even in those cases where reference to legislative history has been deemed appropriate, this Court has made clear that legislative history cannot be employed to add words to a statute that are missing from the statute itself. *United States v. Reorganized C F & I Fabricators of Utah, Inc.*, 518 U.S. 213, 221-22 (1996). Nor can the legislative history of a general and unrelated section of the Bankruptcy Code be used to adopt a rule of interpretation for a separate more specialized section of the Code. *Barnhill v. Johnson*, 503 U.S. 393, 401-02 (1992).

The earliest "contract presumption" cases concluded, solely by reference to the legislative history of § 502(b), that "[o]f

course, there is a presumption that the discount rate and the rate set forth in the contract are equivalent." *Matter of Smith*, 4 B.R. 12 (Bankr. E.D. N.Y. 1980); *Accord*, *Matter of Rogers*, 6 B.R. 472, 475 (Bankr. S.D. Ia. 1980).

In the preeminent "coerced loan" case adopted by the majority below, the Court in *GMAC v. Jones*, *supra*, fallaciously *cited only the legislative history of § 502(b)* as so-called "support for the idea that the contract rate is to be accorded ... privileged significance when determining the appropriate interest rate" in the cramdown context. 999 F. 2d at n. 10. *See also*, In re *Smithwick, supra*, 121 F.3d 211.

This attempted use of legislative history of § 502(b) by coerced loan theorists to support a presumptive contract rate of interest under § 1325(a)(5)(B)(ii) is completely unfounded. As one commentator described:

> The legislative history indicates that in addition to disallowing interest not yet due and payable, any pre-paid interest representing an original discounting of the claim (for example, a cash advance of less than the face amount of a note) is also excluded.... HOUSE REPORT, [H.R. Rep. No. 595, 95th Cong., 1st Sess. 119 (1977)] at 352; SENATE REPORT, [S. Rep. No. 989, 95th Cong., 2d Sess. 12 (1978)] at 62....
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> * * * *
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> This can be conceptualized as discounting the total claim to present value by a factor equal to the contractual rate of interest. In other words, there is an 'irrebuttable presumption that the discounting rate and the contractual interest rate' are the same. HOUSE REPORT, *supra*...at 353; SENATE REPORT, *supra*... at 63.

David Kennedy, "Bankruptcy Reform Act of 1978: Chapter 13 Cramdown of the Secured Creditor," 1981 Wis. L. Rev. 333 at 346, n.74.

Other commentators concur that § 502(b) deals specifically with the process of discounting a pre-petition claim to present value for purposes of accelerating the principal debt as of the petition date, and has absolutely no relevance to the cramdown discount rate under §§ 1129 or 1325. C. Frank Carbiener, "Present Value in Bankruptcy: the Search for an Appropriate Cramdown Discount Rate," 32 S.D. L. Rev. 42 (1987) (citations omitted).

Most significantly, during the legislative process leading to the Bankruptcy Amendment and Federal Judgeship Act of 1984, Congress specifically considered and rejected an amendment requiring the contract rate of interest to be paid under § 1325(a)(5)(B)(ii), despite the urgings of a forceful creditors' lobby. H.R. 1085, 98th Cong., 1st Sess. § 19(2)(A) (1983); H.R. 1169, 98th Cong., 1st Sess. § 19(2)(A)(1983); H.R. 4786, 97th Cong. § 19(2)(A)(1981).

D. Reliance Upon Unsupported and Conflicting Excerpts From Collier Treatise

Much of the confusion that has surrounded the § 1325(a)(5)(B)(ii) present value concept was generated by an editor's comment in the Collier Bankruptcy treatise, where it was submitted in the context of ascertaining present value under 11 U.S.C. § 1129(a)(9)(C), that "deferred payment" of an obligation under a plan is a "coerced loan" for which the creditor must receive a "market rate" of interest corresponding to the rate the creditor would charge to a third party in a like-kind loan. 4 Collier on Bankruptcy, ¶ 1129.03, at 1129-62, 63 (15th ed. 1987).

As described by the court in *In re Computer Optics, Inc.*, 126 B.R. 664, 671 (Bankr. D.N.H. 1991), "without citing any

... authority ..., the Collier treatise took a 'quantum leap' from the present value concept (...time value of money) into a totally different concept of a loan transaction" involving a fact-specific inquiry that has "skewed the analysis ever since."

In harshly criticizing courts' attempts to apply the contract rate for the present value calculation under § 1325(a)(5)(B)(ii) despite the legislature's express rejection of the contract rate, the Collier treatise stated as follows:

> ...contrary to the holdings of a number of courts, it is rarely appropriate to select the rate charged to the debtor in the original transaction as the present value discount rate. Treating the chapter 13 deferral of payments like a new loan transaction, as those courts have done, provides the holder of the allowed secured claim with not only the cost of the funds it would lend but also the costs of the new loan transaction, which would not be incurred, and the profit that would be earned in that transaction...To include them in the present value discount rate would give the holder of an allowed secured claim more than the equivalent of immediate payment of that claim in full.

5 Collier on Bankruptcy ¶ 1325.06, at 1325-37, 38 (15th ed. 1987).[28]

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[28] Compare the factors for which SCS was compensated by the panel majority below, including profit (Pet. App. B at 19a), compensation for depreciation in value of collateral and the creditor's cost of continuing to service the loan (Pet. App. B at 16a). As demonstrated above, the higher the original contract interest rate, the higher the costs saved by the creditor in bankruptcy, Carbiener, *supra*, 32 S.D.L. Rev. at 65.

E. Improper Invocation of *Murel* "Indubitable Equivalent" Doctrine

Another major source of "authority" for advocates of the "coerced loan" theory is the case of *In re Murel Holding Corp.*, 75 F.2d 941 (2d Cir. 1935), which arose under the Bankruptcy Act of 1898 and introduced the concept of "indubitable equivalence." Misapplication of the *Murel* decision played a most decisive role in the erroneous conclusion ultimately reached by the majority below. The majority panel concluded that its application of the coerced loan approach was mandated by the Seventh Circuit *Koopmans* decision, *supra*, 102 F.3d 874. *Koopmans* construed *Murel* as controlling precedent on the "rate of interest" that a secured creditor is to receive under a Chapter 12 cramdown. 102 F.2d at 874-75 (Pet. App. B at 17a).

The precedential value placed upon *Murel* in the cramdown context was finally dispelled by this Court in *Timbers, supra*, 484 U.S. 365. This Court in *Timbers* made the critical distinction that Judge Hand in *Murel* used the words "indubitable equivalence" not with reference to *"interest"* (as it was interpreted by the Seventh Circuit in *Koopmans* and by the majority panel below), but rather "with specific reference to the *jeopardized principal* of its loan" (emphasis added). *Id.* at 378. As noted by this Court in *Timbers*, the necessity for showing something more ("indubitable equivalence") in *Murel* resulted from the plan's lack of proper provision for payment of the principal — *not from use of an insufficient present value discount rate. Id.* at 378. The central premise upon which the panel majority's decision was based -- that discounting to present value requires the undersecured creditor to receive the "indubitable equivalent"[29] of its nonbankruptcy entitlement and

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[29] The "indubitable equivalence" standard was never codified under Chapter 13, and is thus inapplicable to Chapter 13 cramdown. *Cf., Matter*

be placed in as good a position as it would have been had it been entitled to foreclose its collateral and reinvest the proceeds -- derives from a misapplication of the pre-Code *Murel* doctrine. The fact that the cramdown statute did not even exist at the time of the *Murel* decision shows the cramdown statute simply played no part in the outcome.

III. *KIDD* REJECTS CONTRACT RATE IN SIXTH CIRCUIT WHERE COERCED LOAN THEORY ORIGINATED

The most recent Circuit decision issued by the Sixth Circuit in the case of *In re Kidd*, 315 F.3d 671 (6th Cir. 2003) (Pet. App. H at 82a), raises new questions regarding the continued validity of the "coerced loan" or "contract presumption" methods. The *Kidd* case best demonstrates how one Circuit long-saddled with the "coerced loan" theory devised a not-so-discreet method around it.

A. Sixth Circuit in *Kidd* Clarifies That "Market Rate" Concept Was Never Intended to Require Fact-Specific Inquiry Nor Contract Rate of Interest in Cramdown Context

Memphis Bank & Trust Co. v. Whitman, 692 F.2d 427 (6th Cir. 1982) was the first Circuit Court opinion addressing the methodology for determining the cramdown interest rate under 11 U.S.C. § 1325(a)(5)(B)(ii). According to the Court in *Memphis Bank*, the creditor under the cramdown statute makes a new or "coerced loan" to the debtor in the amount of the current value of the collateral, and the most appropriate interest

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of James Wilson Associates, 965 F.2d 160, 172 (7th Cir. 1992) (in determining whether interest received by creditor under § 1129(b)(2)(A)(iii) was indubitable equivalent of oversecured creditor's lien, Seventh Circuit upheld bankruptcy court's imposition of seven-year Treasury bill rate plus 2.5%.

rate is therefore the current market rate for similar loans at the time the new loan is made.

The decision of the Sixth Circuit in *Kidd* required interpretation of what the Court considered the "controlling case" of *Memphis Bank* (Pet. App. H at 83a). The debtors' contract for purchase of a used vehicle in *Kidd* provided for payment of interest at the rate of 20.95% (App. H at 85a). Creditor Household Automotive Finance Corporation submitted evidence of its status as a "subprime" lender, and testimony that the debtors would not qualify for an interest rate of less than the 20.95% contract rate. The bankruptcy court instead accepted (as evidence of "market rate") a weighted average rate of interest of 9.3% for all car loans (both new and used vehicles for all tiers of borrowers) (Pet. App. H at 86a), and fixed the rate at 10.3%, as a result of a recent rise in interest rates (Pet. App. H at 87a). In upholding the bankruptcy court's determination, the Court of Appeals issued a clear directive for courts in the Sixth Circuit to return to the historic present value concept when it concluded that the proper rate of interest to be applied in a Chapter 13 cramdown is:

> ...the current conventional market rate used for similar loans in the region, and not necessarily the contract rate. Such a determination does *not* entail an analysis of any particular debtor's credit rating but rather involves a *more objective determination of the value of money over time so as to compensate a creditor according to the present value of its secured claim.*

(Pet. App. H at 96a) (emphasis added).

The Court of Appeals in *Kidd* firmly rejected the fixing of a rate based upon a creditor-debtor specific inquiry involving the lender's status as a "subprime" lender:

> In fact, adoption of such a rate is tantamount to endorsement of the automatic application of a contract

rate of interest, a principle clearly at odds with the clear language of *Memphis Bank & Trust.*

(Pet. App. H at 92a-93a).

The court in *Kidd* thus stripped the "coerced loan" theory of its most basic precepts.

B. *Kidd* Decision Calls Into Question Continued Viability of Numerous Circuit Decisions Which Have Misconstrued Sixth Circuit Precedent

Because *Memphis Bank* was the first Circuit decision to adopt a "coerced loan" approach, most, if not all, subsequent Circuit decisions adopting a "coerced loan" approach can be traced back to the *Memphis Bank* decision -- and to what has now been exposed by the Sixth Circuit as an erroneous construction of that and subsequent Sixth Circuit cases.

The majority panel in *Till* patterned its decision after the Third Circuit decision in *GMAC v. Jones, supra*, 999 F.2d 63. *Jones*, in turn, adopted *Memphis Bank* as the pivotal case in which the "Sixth Circuit ... stated tersely ... the basic idea of the 'coerced loan' theory." *Id.* at 67-68. The Sixth Circuit's narrow interpretation of the *Memphis Bank* decision in *Kidd* to preclude a presumption in favor of the contract rate lies in sharp contrast to the Third Circuit's expansive interpretation in *GMAC v. Jones,* where the Court of Appeals adopted the contract rate presumption by erroneously interpreting *Memphis Bank* to require that present value be determined from facts specific to the creditor. *Id., citing Memphis Bank, supra*, 692 F.2d at 429.

The effect of misapplication of the decades-old *Memphis Bank* case has been far-reaching. Virtually all courts adopting a "coerced loan" approach prior to *Kidd* interpreted *Memphis Bank* and its progeny to require a loan-specific inquiry with focuses upon the creditor's return on investment. See, e.g.,

Koopmans v. Farm Credit Services of Mid-America, ACA, 196 B.R. 425, 427-28 (N.D. Ind. 1996), *aff'd*, 102 F.3d 874 (7th Cir. 1996), *GMAC v. Jones, supra,* 999 F.2d at 67-70; *United Carolina Bank v. Hall, supra*, 993 F.2d at 1130-31; *In re Fowler, supra*, 903 F.2d at 698; *In re Hardzog, supra*, 901 F.2d at 860, *United States v. Arnold, supra*, 878 F.2d at 930; *Southern States Motor Inns, supra,* 709 F.2d at 651-652, *cert. denied*, 465 U.S. 1022 (1984).

Those Circuits (like the majority below) adopting a presumption in favor of the contract rate of interest have carried this misconstruction to an extreme. Thus, the Fifth Circuit in *Matter of Smithwick, supra*, 121 F.3d at 213-14, cited language from *Memphis Bank* and relied upon *United Carolina Bank v. Hall, Hardzog,* and *GMAC v. Jones* in adopting the Third Circuit's "coerced loan" approach of a rebuttable presumption in favor of the contract rate.

Although the Court of Appeals in *Kidd* thus went a long way in attempting to limit the damage that has occurred through improper extension of the "coerced loan" theory, the Court could not go far enough as a result of the "precedential deference" it was constrained to accord *Memphis Bank* and its progeny (Pet. App.H at 96a).[30]

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[30] The Court of Appeals in *Kidd* fails to address the fact that the conventional bank loan (which served as the basis for the rate adopted by the Court) included the costs of a new loan transaction, profit and other inappropriate charges. Nor does the Court address the effect of this Court's intervening decisions in the *Timbers* and *Rash* cases. The fact that *Kidd* purports to adhere to a "coerced loan" market rate analysis while rejecting the 20.95% subprime lender's contract rate illustrates the complete arbitrariness and lack of uniformity of the "coerced loan" approach.

IV. FORMULA METHOD AS MEANS FOR RETURN TO HISTORIC PRESENT VALUE CONCEPT

A. Presumed Contract and Coerced Loan Methods Impermissible As Matter of Law

The precise rate of interest to which a creditor is entitled to preserve the present value of its claim under § 1325(a)(5)(B)(ii) is a question of fact to be determined by the bankruptcy court reviewable for clear error, whereas the question of statutory interpretation, including the factors that the trial court is permitted to consider and the components for which the creditor may be compensated, are legal issues subject to *de novo* review, (Pet. App. A at 6a), and properly before this Court for establishment of national guidelines.

It has been suggested that use of significantly different discount rates by experts in the same or similar cases reflect a fundamental misunderstanding of the discounting process. W. Cris Lewis, "The Role of the Discount and Reinvestment Rate in Calculating Future Economic Loss," 34 Fed'n Ins. Couns. Q. 223 (1984). Petitioners contend that, in order to restore a level of uniformity appropriate to a national system of bankruptcy laws, courts must return to the historic concept of discounting to present value, which does not rely upon fact-specific characteristics of the creditor or debtor. With the adjustments essential to discounting under Chapter 13, the appropriate interest rate should fall within a limited range regardless of the identity of the debtor or creditor, the location court in which the determination is made, or the specific nomenclature employed.

Petitioners contend that the Seventh Circuit's adoption of the "coerced loan" or "presumed contract" rate as the present value discount factor constitutes reversible error, as a result of the majority panel's misapprehension of the limited purpose of

the discounting process and resulting compensation of the creditor for factors inappropriate to the discounting process.

B. Calculation of Present Value for Purposes of Section 1325(a)(5)(B)(ii) Must Begin With Risk-Free Rate of Interest

As demonstrated above, in the economic and financial communities, the "discount rate" is universally understood to consist of two components: 1) a riskless rate to account for the time value of money and 2) an adjustment to account for risk. Richard A. Brealey and Steward C. Myers, Principles of Corporate Finance 244 (6th ed. 2000). The formula method is thus the most effective means to an end in this process.

The discount rates applied by the courts have been divided into various classifications, including: 1) the rate on government securities; 2) the federal civil judgment rate set by 28 U.S.C. § 1961; 3) a rate arrived at by averaging or blending; 4) the contract rate; 5) the current market rate for similar loans ("coerced loan" method); 6) the I.R.S. rate set by 26 U.S.C. § 6621; 7) the rate the creditor must pay to replace the funds ("cost of funds" approach); and 8) the prime rate.[31]

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[31] The bankruptcy court in *Till* approved a prime-plus (1.5 risk factor) formula consistent with the approach adopted by the court in the case of *In re Carson*, 227 B.R. 719 (Bankr. S.D. In. 1998). Use of the prime rate in addition to a risk factor has been criticized as overcompensating the creditor. The Court in *In re Fisher*, 29 B.R. 542, 548 (Bankr. D. Ka. 1983), concluded that "prime" is really a form of contract rate for low-risk customers, and that elements of profit and administration costs are included. The plan payout on the SCS secured claim occurred over an approximate one-year period of August 2000 – June 2001. The prime rate on the petition date was 8%; the comparable Treasury bill rate for bills of one-year maturity in 1999 was approx. 4.78%. Federal Reserve System, www.federalreserve.gov/releases. Petitioners contend that the bankruptcy court's use of prime plus 1.5 risk factor exceeded the minimal requirements

Carbiener, *supra*, 32 S.D. L. Rev. 42, examines several of the most common rates. According to Carbiener, all market-sensitive rates which reflect the "time value of money" are 1) responsive to economic conditions existing when the rate is set and 2) easy to calculate. *Id.* at 58. Carbiener assesses the characteristics of each rate for adaptability to the bankruptcy cramdown setting, including adjustments for the duration of the payout period and plan payment terms.[32] *Id.* at 64.

Using a process of elimination, Carbiener concludes that, of the above rates that are market responsive and easy to calculate, only the rates based on government securities do not contain a premium for profit. Although Carbiener considers rates based on government securities to provide the most straightforward approach to an appropriate discount rate, the Carbiener analysis demonstrates that the same result could have been reached by more than one method properly applied. *Id.* at 60.[33] Thus, although certain rates may serve as more

for confirmation, given the elements of profit and costs included in the prime rate, the short payout period of the SCS allowed secured claim, and the creditor's lack of showing of any special risk.

[32] Carbiener points out that most bankruptcy courts have not factored into the present value equation the duration of the payout period or the fact that the typical Chapter 13 involves periodic principal payments plus interest. In contrast, the terms of a government security require periodic payment of interest only, with the entire principal due at the end; the difference is significant because under a plan, the creditor has the use of an increasing portion of its principal claim beginning with the first plan payment, whereas the purchaser of a security is deprived of the use of its money for the entire loan term. *Id.* at 64-65.

[33] Judge Rovner, in her dissent below, recommends a formulaic approach that employs as a base an easily referenced rate like the rate of U.S. Treasury instruments or prime rate, and allows for modest enhancement to the base to account for the risk of nonpayment, *citing Valenti & Doud*,

effective base rates because they require fewer adjustments, these analyses demonstrate that the key to any formulaic approach to Chapter 13 discounting is the elimination of improper elements of creditor compensation.

C. The Diminishing Risk Factor

A decade before this Court's issuance of the *Rash* decision, Carbiener recognized that the risk associated with deferred payments under a Chapter 13 should not be overstated.

A finding of feasibility under 11 U.S.C. § 1325(a)(6), for instance, fixes the court's endorsement that, despite the bankruptcy filing, the debtor is creditworthy for reorganization purposes. *See, e.g., In re Ridgewood Apts. of DeKalb County, Ltd.*, 183 B.R. 784, 792 (Bankr. S.D. Oh. 1995) ["If a plan of reorganization is feasible, qualification of the 'borrower' is established"].

Other nonbankruptcy market-risk factors are similarly eliminated under Chapter 13. Any risk that the debtor has overextended himself by entering into undisclosed obligations is eliminated as a result of extensive disclosure requirements. Most of the costs of administration of a "loan" are handled by the Chapter 13 trustee under § 1325(a)(5)(B)(ii), and the *debtor* — not the creditor — must pay the trustee an additional fee based on a percent of the funds the trustee distributes. The trustee becomes the "collecting agent" for the creditor, but with statutory and court backing — and thus with powers far exceeding the average nonbankruptcy collecting agent. The creditor's costs are thus greatly reduced by the presence of the trustee. *Fisher, supra*, 29 B.R. at 545. The Court in *In re Carson, supra*, 227 B.R. at 723, agreed that the risk premium

supra, and Carbiener at 63-65. The court in *Carson, supra*, 227 B.R. at 723, reasons that, since, with appropriate adjustments, the final interest rate will be the same whether the court starts with the prime rate or the T-bill rate, the choice of nomenclature is irrelevant.

should be minimal in Chapter 13. The creditor's primary protection against risk derives from the creditor's right to seek adequate protection under 11 U.S.C. § 361 at the outset of the case, from its right to retain its lien, from payment by wage assignment orders which substantially reduce the risk of non-payment, from the debtor's restructure of unsecured debt, and from the creditor's right to seek dismissal of the case in the event of a material default which would restore the creditor's pre-bankruptcy remedies. The court further recognized that, in consumer transactions in which APRs are high, the primary factors determining these rates do not relate to risk especially where the debt is secured, but instead to high costs of marketing, high transaction fees, and consumers' failure to effectively shop for lower rates due to various imperfections in the market.

The Court in *Valenti*, *supra*, 105 F.3d 55, considered the pre-*Rash* norm for risk rates throughout the country to range from 1 to 3%. Carbiener concluded that because cases using the government securities approach fail to recognize the cost premium included in government rates, a maximum risk premium of 1% should be adequate unless a creditor can prove that the risk of loss (as opposed to the risk of default) requires a greater premium. *Id.*at 62-63.

(Rash Inclusion of Cramdown Risk in "Value" Component of Present Value Equation)

It has been said that "questions about cramdown interest rates and risk adjustments thereto really are asset valuation questions..." Halligan, *supra*, 11 Am. Bankr. Inst. L. Rev. at 175. The higher the interest rate, the less principal required to produce a given "present value." Irving Fisher, in his classical treatise, The Theory of Interest, *supra*, at 37, stated what he described as the then "seldom ... recognized" fact that any increased burden to the debtor in the principal may be "offset by a reduction in the rate of interest." In present value

analysis, the higher the value assigned to the collateral, the lower the discount factor necessary to preserve the value of the "allowed secured claim." From economic and accounting perspectives, it has been suggested that a creditor concerned with a risk of subsequent default should seek a higher principal (value) and lower interest rate if possible. Chaim J. Fortang & Thomas Moers Mayer, "Valuation in Bankruptcy," 32 U.C.L.A. L. Rev. 1061, 1115 (1985).

This is precisely the choice made by the creditor in *Rash*, *supra*, when it argued for a replacement rather than foreclosure valuation standard for Chapter 13 cramdown. In its merits brief before this Court, Associates Commercial Corporation, at the time an 80-% owned subsidiary of Ford Motor Corporation, justified use of the proposed higher valuation standard as follows:

> ...To be sure, the secured creditor is afforded somewhat greater protection [by replacement value],[34] but that simply reflects the greater risk that the secured creditor assumes by not being able to repossess the collateral. That certainly is a fair exchange for having a plan crammed down over the creditor's objection.[35]

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[34] In August 2002, Ford Motor Credit reported that "...used-vehicle prices are off. The average auction price of an off-lease Taurus was $10,750 in Oct. 2000. It was $8,650 in March [2002]. Other models fared no better." This suggests a widening of the gap between the *Rash* replacement value that the debtor must pay to retain a vehicle and the amount the creditor would receive had the debtor surrendered the vehicle. "Ford Credit Refocuses to Recover From Losses," auto_ford_credit_refocuses.htm.

[35] The debate at that time may best be expressed by Justice Steven's dissent in *Rash*:

> "The Court states that 'surrender and retention are not equivalent acts' from the creditor's perspective because he does not receive

Associates Commercial Corporation v. Rash, Petitioner's Merits Brief filed February 28, 1997, Case No. 96-454.

This Court in *Rash* concurred with the creditor that **"[a]djustments in the interest rate do not fully offset"** the **risks of debtor default and property deteriorat(ion)**, incurred by the creditor when the debtor retains the collateral, whereas the **replacement-value standard accurately gauges the creditor's exposure to these "double risks"** occasioned by the debtor's continued use of the property. 520 U.S. at 962-63 (emphasis added).

In her dissent below, Judge Rovner concluded that by requiring the debtor to pay the creditor the (higher) replacement value of the vehicle, "the Supreme Court has already ensured that the creditor will be afforded significant compensation for the risk of non-payment." (Pet. App. B at 30a). It is thus significant that, with the exception of *Till*, *Smithwick*, and *Kidd*, all Circuit decisions adopting the

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the property and is exposed to the risk of default and deterioration.... I disagree. That the creditor does not receive the property is irrelevant because, as § 1325(a)(5)(B)(ii) directs, he receives the present value of his security interest. Present value includes both the underlying value and the time-value of that interest. The time-value component similarly vitiates the risk concern. Higher risk uses of money must pay a higher premium to offset the same opportunity cost. In this case, for instance, the creditor was receiving nine percent interest, see In re Rash, 90 F.3d 1036, 1039 (CA5 1996) (en banc), well over the prevailing rate for an essentially risk-free loan, such as a United States Treasury Bond. Finally, the concern with deterioration is addressed by another provision of the Code, 11 U.S.C. § 361, which authorizes the creditor to demand 'adequate protection,' including increased payments, to offset an derogation of his security interest during a cram down.

520 U.S. at 966.

"coerced loan" or "presumed contract" rate approach pre-date the *Rash* decision.

So decisive was the *Rash* decision in shifting the risk-component of the present value calculation to the value side of the equation, that courts considering the issue subsequent to *Rash* have significantly limited the risk factor -- or eliminated the risk factor entirely.

The Court in *In re Goodyear*, 218 B.R. 718, 721-22 (Bankr. D. Vt. 1998), noted that *Rash* shifted compensation for the risk of default and property deterioration from the "interest" component to the "valuation" component of the present value equation. Accordingly, the Court determined the interest rate to reflect the present value of the bank's claims to be fixed at the rate on a U.S. Treasury instrument closest in maturity as of the date of plan confirmation, with no additional "default premium."

If the risks of "debtor default" and "property deterioration" are "accurately guaged" by the replacement value as indicated in *Rash*, the creditor is adequately protected and the plan is feasible, additional compensation for these risks in setting the cramdown interest rate vividly illustrates the potential for overcompensation.

CONCLUSION

Petitioners contend that a formula method,[36] with the necessity and amount of risk adjustment to be determined by the bankruptcy court, best satisfies the qualities of the historic present value concept, in that this approach is sensitive to market forces, objective, easily ascertained, and adaptable to the length and payment terms of the Chapter 13 plan. This

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[36] The formula must begin with a risk-free base or have all inappropriate elements of creditor compensation removed.

approach serves an important streamlining function in an area of law that arises frequently in reorganization cases, and reduces the delay and expense of protracted litigation in proceedings that are already too time-consuming and costly. One of the various formula methods also maximizes equality of distribution amongst creditors, increases uniformity in the courts, and complements the rehabilitative purpose of Chapter 13.

For the foregoing reasons, Petitioners respectfully request that the judgment of the Court of Appeals be reversed on grounds that the "coerced loan" and "presumptive contract" methods are inappropriate as a matter of law, and that the cause be remanded for proceedings consistent herewith.

Respectfully Submitted,

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